Second, the Commission should adopt logical service groupings, based on a combination of service category and customer segment. Price cap exchange carriers should have the option of making a showing for one or more of these market segments, each of which would comprise a group of substitutable services provided to a given customer segment within a particular geographic area. This option would establish a relevant market which would more accurately reflect the substitutability of services. Further, because these market segments would be less numerous than price cap categories, this approach would make the plan easier to administer by minimizing the number of separate showings the Commission must review for each geographic area. The structure of these particular service groupings will be described below.

3. <u>Customer</u>.

The substitutability of services may depend upon the particular characteristics of the end user location where the traffic is being originated or terminated. Use of this dimension will enhance the market classifications available to the Commission.

In order to deliver interstate traffic to or from a large business customer, an interexchange carrier may choose to purchase switched access from the exchange carrier. Alternatively, the interexchange carrier can establish a direct connection between the end-user customer's location and the interexchange carrier's point of presence using special access purchased from the exchange carrier or from an alternative provider, such as a CAP. The interexchange carrier will provide the switching capability.[62] In either case, the service ultimately provided to the end-user

[62]This access will most often be ordered by the interexchange carrier, but may also be ordered directly by the end-user. In either case, it is the end-user's volume, rather than the

is switched interexchange service.[63] For these large end-user locations, therefore, a combination of special access and switching provided by another entity, such as an interexchange carrier, are substitutable for switched access.

However, for an end user location which generates only a small volume of interstate traffic, special access may not be a reasonable substitute for switched access because the interstate access traffic may be insufficient to utilize a special access circuit efficiently.[64]

If a special access direct connection is established for a large end user location, that end user may continue to purchase local dial tone service separately from the exchange carrier.[65] For large end users, then, the choice of access provider is separable from the choice of local service provider. In contrast, a smaller end user location is likely to use the same network link for both local service and interstate access, since it cannot justify a separate line for long-distance alone. For these smaller customers, the choice of local service is not separable from the choice of long-distance service.

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identity of the interexchange carrier, that primarily determines the opportunity to substitute special access for switched access.

[63]Interexchange services based on switched access include MTS, Reach-Out and Pro-WATS. Switched interexchange services based on special access include service such as Megacom. The function provided to the end-user is nearly identical and these services are highly substitutable for one another.

[64]Smaller volume customers may have opportunities to utilize special access when they are located in such a way as to facilitate the aggregation of traffic from several such customers. This may occur in a multi-tenant building, an industrial park or a university campus.

[65]Of course, if the access provider is also a local service provider, the end user may choose to purchase both access and local services from the alternative carrier.

For similar reasons, large and small end user locations may have different alternative sources of supply open to them. Suppose, for example, that a CAP offers fiber-based high capacity services throughout a geographic area. The CAP will naturally target customer locations large enough to justify the high capacity service. These large end user locations will therefore have a substitute available for both the special access and the switched access services of the exchange carrier. However, a small customer location in the same area may not have access alternatives available, either because the CAP does not target small customers or because the CAP's highcap service would not be economic for that customer.

If the alternative access provider is a cable company or a PCS provider, the substitution opportunities may be similar for both small and large end user locations. Such a carrier may offer service to both small and large volume locations and may offer local dial tone service, switched access and special access.

Because the volume of interexchange traffic generated by an end user location affects both the availability of alternatives and the substitutability of these alternatives, USTA proposes that (end user) customer size could be one of the dimensions that defines a market segment.[66]

In general, large end user locations will have alternatives available when a CAP offers service in an area. This alternative would be substitutable for either switched or special access provided by the exchange carrier. For these locations, the availability of local exchange alternatives would not be a necessary condition for the availability of access alternatives.

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[66]Again, this is not meant to suggest that the end user would be the customer of record for the long-distance service provided to a given end user location. In most cases, an interexchange carrier would be the access customer.

In general, small end user locations will have alternatives available when a new provider of local exchange service, such as a CLEC in states where competition is allowed, cable or PCS provider, offers service in an area.

4. <u>Use of the Three Dimensions to Define the Relevant Market Area</u>.

As explained above, the Commission should define the relevant market area as a grouping of substitutable services provided to a given customer segment in a particular geographic area. An exchange carrier should have the option of making a competitive showing for one or more relevant markets. Once the showing is made, streamlined regulation should apply to all of the services within the relevant market.

In addition, as noted above, the customer dimension of the definition of a relevant market area could be based on a distinction between large and small end user locations. This distinction could then be combined with the other dimensions to define logical market areas. Following are three examples of how the streamlined model could be achieved. While there will be others, these examples could be found to justify streamlined regulation as they reflect the current patterns of the competitive market. These examples also explain how the different dimensions can be demonstrated without the need for separate showings.

1). If alternative carriers can address the exchange carrier's wire enters in a geographic area, then the interoffice transport to and from the addressable offices and the facilities between the serving wire center and the POP have substitutes available. A single showing would apply to this segment demonstrating that the demand for these services represents a sufficient proportion of total demand in this market. Since interoffice transport comprises aggregated traffic from both large and small end user locations, the customer size dimension is not relevant to this market.[67]

2). If alternative carriers can address a sufficient proportion of the large end user locations within the geographic area, then a single competitive showing should apply to all substitutable service provided to and from these locations. This would include special access channel terminations to those locations, as well as local switching and CCL charges applying to traffic originating from or terminating to those locations.[68]

3). If alternative carriers can address a sufficient proportion of small end user locations within a geographic area, then a single competitive showing should apply to all substitutable services provided to and from those locations. This would include local switching transport and Carrier Common Line charges applying to traffic originating from or terminating to those locations.[69]

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[67]This example would include all interoffice special access transport. Subject to a showing with respect to the availability of tandem signaling, it would also include tandem switched transport and tandem switching.

[68]It is likely that if a sufficient number of end user locations are addressable to make such a showing, then the exchange carrier wire centers in the area will also be addressable. If this is true, then the same showing should include both transport channel terminations and the interoffice transport in one relevant market.

[69]If alternative carriers address large end users and small end users in the geographic area, then an exchange carrier may be able to make a single showing which would include all three of the market segments defined here.

5. The Relevant Market Area and the Price Cap Basket Structure.

The dimensions of the relevant markets proposed by USTA would be compatible with the proposed basket structure and the optional structure described above. If an exchange carrier makes a showing for a price cap service category, that category should be afforded streamlined regulatory treatment for the given geographic area. If an exchange carrier makes a showing for one or more of the relevant market areas proposed above, the combination of services which comprise the relevant market areas should be afforded streamlined regulatory treatment for the geographic area. In the case of transport service, this will involve the removal of several service categories. In the case of the large customer market segment, this would involve removing the demand associated with large end user locations from the local switching and CCL categories.

B. Addressability Should be Used to Determine When Streamlined Regulation is Appropriate.

USTA has proposed a conservative measure of competition that focuses on the proportion of demand in a relevant market area that is addressable by alternative providers. Unlike market share, addressability is a forward-looking indicator that seeks to determine if customers have alternative choices. Addressability shows the availability of alternative supply from other providers.[70] Contrary to the Commission's assumption, addressability includes capacity.[71] For

[70]The alternative supplier does not have to be located within the incumbent's serving area. Technology is broadening the availability of services such that geographic area is no longer a limiting factor. For example, directory assistance can be provided by a multitude of providers in multiple areas without requiring an actual facility in each area where the service can be obtained. Therefore, the competitive footprint should be the area where the service is available, not where the supplier is based.

[71]2nd FNPRM at ¶ 139.

example, carriers using fiber to reach customers will certainly have the capacity to provide service.[72] Addressability also resolves any issues regarding barriers to entry. Since addressability includes carriers with facilities in place, entry obviously has occurred.[73]

Allowing streamlined regulation based on addressability will provide protection against any concerns raised in the 2nd FNPRM. Addressability measures the availability of firms to expand in various markets. This is particularly useful where exchange carrier access services are homogenous services sold as intermediate goods to a small number of large, sophisticated buyers. Addressability has four additional advantages. First, it measures forward-looking pressure on price in the market rather than historical pressure. Second, it can reduce the measurement bias from self-supply. Third, it avoids the disincentives, which could be created under a market share analyses, to lose customers in the short run. Fourth, it alleviates the risk of a pricing umbrella by gauging the ability of a provider to serve.

The measure of addressability is based on observable fact, the physical presence of alternative providers with the capacity and coverage to provide a viable alternative. In order to validate this measure, all interstate access providers must report to the Commission all of the information required to make a determination as to whether customers in a relevant market have alternatives to the incumbent exchange carriers. Specifically, the Commission should require all

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[72]See, Bell Atlantic Ex Parte, CC Docket No. 91-141, June 12, 1992 at Attachment A which explains that ICC, a Washington D.C. based CAP, has sufficient capacity to allow ICC to carry nearly seven times Bell Atlantic's current DS3 and DS1 miles in the Washington metropolitan area.

[73]However, the Commission should acknowledge that resale of local exchange service is often an early indicator of where facilities-based competition will develop.

such providers to file a description of the area in which they make each of these services generally available to all customers. This requirement can be satisfied by a general description of the service area (e.g., listing of zip codes served, city or county boundaries, or exchange carrier wire centers), or by filing a service area map. If the Commission does not require such a filing or if the alternative access provider does not make its service generally available to the public, the alternative provider should be required to file, on an annual basis, detailed maps showing their network facilities within each area served, including planned additions. Further, the data reported must be appropriate to the relevant services and relevant market areas. Reporting national figures has no value for the assessment of the small market areas that will be defined under USTA's approach. In addition, it must match any competitive criteria which is actually adopted. Exchange carriers should not be responsible for reporting data regarding their competitors as they do not and should not have access to such data. Attached hereto is a detailed proposal describing the data reporting requirements.[74]

C. <u>Elements of a Competitive Showing.</u>

1. <u>Supply Responsiveness</u>

An exchange carrier could demonstrate supply responsiveness by showing that 25 percent of the exchange carrier's access demand in the relevant market have choices available from another provider/providers. As an alternative, an exchange carrier could demonstrate that customers representing 25 percent of the total interstate demand within the relevant market had

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[74] Attachment 8.

alternative choices.[75] The latter would provide an exchange carrier with the opportunity to seek streamlined regulation in a market where much of the addressable demand had already switched to a competitor.

The addressability showing would compare relevant market demand of customers in the footprint with total demand in the relevant market. Where the relevant market includes services sold in different units, a reasonable equivalent could be established to express all demand in a common unit such as minutes or DS-1 equivalents similar to procedures developed for purposes of the zone density plans.

Exchange carriers should also have the option of comparing relative lines, relative land area or relative revenue for purposes of the showing. Relative lines or land area would be most suitable to a showing for a small customer segment since competitors will presumably target areas and customers with high demand first. Relative revenue would be most suitable for a large customer showing since the largest volume customers probably pay the lowest unit price.

2. <u>Demand Responsiveness</u>

Exchange carriers would submit evidence to demonstrate that customers regard the services used to demonstrate addressability are acceptable substitutes for exchange carrier services and that they are willing to utilize those alternatives.

Such a showing would consist of evidence that customers in the same market had switched to the competitors' services, or that customers were using the services of the same or

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[75] Attachment 9 provides an example of how the supply responsiveness would be calculated.

similar providers in other markets. This acknowledges that the access market is different from the long distance market. Since the Commission treated interexchange as a single, national market, it did not have any other market from which it could gain information on demand. In access markets, competition will develop at different rates in different areas. Customer acceptance of alternatives in one access market can be used to demonstrate that the same alternatives will be acceptable in another market. Exchange carriers should not have to wait until a uniform threshold level of demand has been reached in every market.

3. **Addressability for the Small Customer Segment.**

In addition to the showings of supply and demand responsiveness described above, in order to show addressability for the small customer segment (i.e., single line switching and single line Carrier Common Line for traffic originating or terminating at small customer locations) the exchange carrier would also show that the state has allowed local competition and at least one competitor has been certified to provide service and is operational.

4. **Market Share is a Poor Proxy for Market Power.**

Market share should not be used to determine market power. Market share as a criterion predetermines the outcome of competition since it reserves a certain portion of the market for competitors before the incumbent is permitted to respond. As a result, customers do not receive the full benefits of vigorous competition, particularly if the established exchange carrier rate is used as a price umbrella for new entrants. This, in turn, sends incorrect price signals to entrants which could cause inefficient entry decisions. Moreover, a predetermined target level for market share creates perverse incentives to the incumbent firm and essentially requires a determination that a specific portion of the market should be served by competitors before an exchange carrier can respond regardless of economic conditions. "Such a regulatory plan effectively greenhouses competition for a period, sending false signals to entrants, and denying customers the lower prices that ordinary competitive response to entry would produce."[76]

The Commission also requests comment on whether highly elastic services priced below the price cap over a sustained period of time is an indicator of competitive pressure.[77] As noted above, reduced prices are one of the public interest benefits of competition. In order to achieve that benefit, the Commission must eliminate the regulatory requirements which prevent exchange carriers from responding to competition. Pricing below the cap may be an indicator of competitive pressure, however, pricing at the cap does not mean that there is no competitive pressure. Thus, it would not be prudent for an exchange carrier to lower all prices within the same basket, unless competition demands it. In addition, the formula-driven, compounding effect of the current price cap plan discourages such pricing. Actions, such as the Commission increasing the up-front, productivity factor reduction, it becomes more difficult to sustain pricing below the cap over time. In addition, the current rules, which severely restrain any price increases following price reductions, encourage pricing at or near the cap. Sustained pricing below the cap could also reduce the subsidies necessary to offset shortfalls generated by services priced below cost. Thus, until comprehensive universal service reform is completed, this

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[76] Schmalensee and Taylor at p. 26.

[77] 2nd FNPRM at ¶¶ 144-45.

practice is not always feasible. Finally, the Commission must acknowledge the differences among price cap companies. Companies that have already lowered access prices would have a difficult time eliminating additional costs in order to be able to continue pricing below the cap over time.

D. <u>Pricing Flexibility Under Streamlined Regulation</u>.

Services subject to streamlined regulation would be removed from price cap regulation. By taking service out of price cap regulation, the Commission will allow much-needed flexibility. It also serves as a safeguard for areas that are less competitive because removing competitive markets from price cap regulation prevents recouping competitive losses from the less competitive markets. No Part 69 rate structure requirements would be applied to the streamlined services. All tariff filings, including contracts, would be introduced on fourteen days notice with no cost support. Exchange carriers should be permitted to offer any streamlined service on a contract basis.

IV. NON-DOMINANT TREATMENT SHOULD BE AVAILABLE BASED ON THE <u>RELEVANT EXCHANGE CARRIER ACCESS MARKETS</u>.

As the Commission explains, non-dominant status should be available when the relevant market is determined to be competitive such that a service provider cannot exert market power. The Commission recently reclassified AT&T as a non-dominant carrier which places AT&T on an equal footing with its competitors.

A non-dominant showing can be made for the same relevant markets as described above for streamlined regulation. Given the narrow scope of the relevant markets, exchange carriers could have nondominant status for particular services or in particular geographic areas or for particular classes of customers while maintaining baseline or streamlined regulation in others. An exchange carrier should also be permitted to make a non-dominant showing for some large aggregation of markets that had previously been streamlined.

The competitive criteria of addressability as well as the demand responsiveness characteristics utilized for streamlined regulation would also be applicable for a determination of nondominance. For markets that have been previously streamlined, only a showing of supply responsiveness would be required. However, the threshold should reflect the increasing intensity of competition to justify the corresponding relaxation of regulation. Therefore, in order to obtain a declaration of nondominance, exchange carriers should be required to show that customers representing fifty percent of the incumbent exchange carrier's interstate access services demand within the relevant market area have an alternative supply available to them. Fifty percent is a conservative threshold. A cable system is deemed to be subject to sufficient competition to justify complete deregulation if a competitor offered service to at least fifty percent and served more than fifteen percent of the households in a franchised area.[78]

In addition, the exchange carrier should also demonstrate full compliance with state requirements to open the local telecommunications markets. The creation of specific rules for

[78]Implementation of Sections of the Cable Television Consumer Protection Action of 1992, Rate Regulation, Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-177, released May 3, 1993.

local competition should be left to the state commissions to reflect the circumstances evident in each state.

Once a relevant market area is determined to be nondominant, exchange carriers should be permitted to file tariffs on one day's notice, as exchange carrier competitors and AT&T currently do. Such tariffs shall be presumed lawful.[79] Any other flexibilities permitted non-dominant carriers should be adopted for exchange carrier markets which are declared to be non-dominant.

V. ACCESS CHARGE REDUCTIONS SHOULD BE FLOWED-THROUGH TO CUSTOMERS.

The Commission should require all interexchange carriers to flow through reductions in access rates on a dollar-for-dollar basis by appropriate changes to their own rates.[80] While the Commission's recent action to declare AT&T non-dominant may have mooted this issue in this proceeding, as USTA has recommended, the Commission must address the implicit subsidies currently embedded in access rates and permit rebalancing of rates to remove implicit subsidies. To maximize the consumer benefit of these actions, interexchange carriers must flow through reductions in access charges on a dollar-for -dollar basis.

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[79]The Commission has found that significantly streamlined filing requirements for nondominant common carriers serve the public interest by promoting price competition, fostering service innovation, encouraging new entry into various segments of telecommunications markets and enabling firms to respond quickly to market trends. Tariff Filing Requirements for nondominant Common Carriers, CC Docket No. 93-36, Memorandum Opinion and Order, 8 FCC Rcd 6752, 6761 (1993).

[80]See, 47 C.F.R. § 61.44(b) and Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8962 (1995) at ¶ 48.

VI. CONCLUSION.

The changes proposed herein for baseline price cap regulation should be adopted to ensure that regulation adequately reflects the current access market. As competition continues to increase, regulation should be streamlined based on the appropriate geographic, service and/or customer market where alternatives are available. Ultimately, exchange carriers should be afforded nondominant status. USTA urges the Commission to adopt an adaptive regulatory structure as described in these comments.

Respectfully submitted,

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December 11, 1995

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ATTACHMEN...

Pricing Flexibility for

Interstate Carrier Access Services

by

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PRICING FLEXIBILITY FOR

INTERSTATE CARRIER ACCESS SERVICES

I. EXECUTIVE SUMMARY

In its Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1,[1] the Federal Communications Commission (FCC) sought comments on proposed reforms to its regulation of local exchange carrier (LEC) interstate carrier access prices. In broad strokes, the FCC envisioned changes in regulation falling into three categories: (i) changes to current price cap regulation, (ii) the application of streamlined regulation to services facing substantial competition, and (iii) the treatment of particular LEC services in particular geographic areas as nondominant upon a showing of the absence of substantial market power. In these comments, we address economic criteria that should be used to determine when these different degrees of regulation should be applied to different LEC services in different geographic areas.

We have six principal conclusions:

- Two immediate changes to baseline regulation -- a more rapid introduction of new services and implementation of flexible alternative pricing plans -- would increase efficiency in current carrier access markets without increasing the likelihood of anticompetitive behavior on the part of the LEC.

[1]Price Cap Performance Review for Local Exchange Carriers, Treatment of Operator Services Under Price Cap Regulation, and Revisions to Price Cap Rules for AT&T, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, Released September 20, 1995 (Second Further Notice).

- When a carrier access market is opened to competition, regulation in that market must be competitively neutral: i.e., as symmetric as possible across actual and potential competitors, consistent with control of the vestigial market power of the incumbent firm.

- When market forces can prevent the exercise of market power in any geographic and product market, for particular customer segments, regulatory restrictions should diminish proportionally.

- Introduction of streamlined regulation in relevant markets (geographic, product, and customer segment) where customers representing at least 25 percent of demand have an alternative source of carrier access services would provide necessary pricing flexibility for the LEC to meet competition without exposing customers to risk from exploitation of remaining market power.

- A structural standard that is more stringent than that for streamlined regulation is prudent for the classification of a LEC as nondominant in a particular relevant market, consistent with the maximum level of reduced regulation associated with nondominance.

- Finally, recognizing that historical measures of market concentration may be poor predictors of future market power, more emphasis should be placed on monitoring and less on predicting the effects of regulatory relaxation. Thus streamlined and nondominant regulatory treatment should be implemented -- based on the simple structural tests proposed here -- and any doubt regarding remaining market power should be resolved by monitoring the course of competition in the market.

II. BACKGROUND

Many telecommunications markets are neither perfectly competitive nor obviously monopolized, and in such markets, the regulator must determine the appropriate form of regulation using methods that are consistent with current economic thinking and that properly reflect the limited ability to measure competitiveness precisely in an adversarial setting. In economic theory, as markets that have been historically organized as regulated monopolies are opened to competition, there are two distinct events that should trigger distinct changes in regulation:

- **Baseline:** Current regulation must be sensitive to the need for competitive equity. While regulation must continue to limit the ability of the regulated firm to exercise market power, it must also provide neither the entrant nor the incumbent any net advantage on a forward-looking basis. Such regulations would encourage the offering of new services and remove price distortions.
- **Streamlining and Nondominance:** When competitive forces effectively constrain the prices of the regulated firm in particular relevant markets (i.e., product, geographic or customer segment), regulation of those prices no longer provides benefits to offset its costs, and regulation should accordingly be effectively eliminated in those markets.

The first change in regulation is intended to send correct economic signals. This change must occur so that entrants and incumbents make efficient entry and exit decisions, some of which entail large investments and sunk costs. In particular, such flexible regulation should begin before there is any evidence that competitive forces can discipline the pricing decisions. A considerable movement towards competitively-neutral regulation can be achieved by permitting downward price flexibility and volume, term, other non-linear and promotional pricing and by removing such regulatory restrictions as (i) the requirement to charge only geographically averaged rates, (ii) delays in filing tariffs and implementing new services due to the FCC's Part 69 rules, and (iii) cost support requirements.

Economic theory is reasonably clear concerning the second sort of change listed above: replacement of regulation with market forces when competition can be demonstrated. As soon as a market is open to competition, the terms of that competition should be made as symmetric as possible, consistent with the obligation to limit the ability of the regulated firm to exercise market power. If market forces can prevent the exercise of market power, regulation should diminish proportionally. Thus, if current competitors can supply a sufficiently close substitute to the service to prevent a small but significant[2] price increase above the competitive level or if entry barriers are so low that the threat of new entry can discipline the market price, market forces will provide the economically correct pricing signals to the market participants.

In considering regulatory reform in practice, the correct question is not only whether a given firm can exercise control over the price in a given market but whether the benefits of a proposed regulatory modification will outweigh the costs in the imperfect markets in which telecommunications services are sold and regulated. This point gives rise to several concerns of a practical nature.

First, care must be taken that the perfect not be the enemy of the good in competitive analysis. Market power is generally defined as the ability of a firm (or group of firms acting in concert) to set price profitably above the competitive level, which is generally taken to be incremental cost.[3] Market power is thus conventionally measured relative to the standard of perfectly competitive markets.[4] Since real world markets are rarely perfectly competitive, however, nearly all firms possess some amount of market power. Economic theory provides no bright-line distinctions in this area.

Thus, while reasonable analysts should agree in general on the indicia of competition in a market, one cannot expect agreement in an adversarial proceeding on the degree of market power that should trigger special regulatory treatment or on how the different indicia should be combined to provide an overall assessment of market power in the case at hand. How much

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[2]U.S. Department of Justice and Federal Trade Commission, "Horizontal Merger Guidelines," April 2, 1992. p. 32 (*Merger Guidelines*).

[3]In this context, incremental cost includes normal profit. However, the level of margin above the price floor should be dependent on the level of competition in the market. This is consistent with the FCC's position that "[t]he LEC may, but does not have to, add a level of overhead costs to the direct costs to support the proposed price of a new service..." (Second Further Notice, at ¶ 41). See, e.g., W.M. Landes and R.A. Posner, "Market Power in Antitrust Cases," Harvard Law Review, 94, 1981, p. 937, or R. Schmalensee, "Another Look at Market Power," Harvard Law Review, Vol. 95 (June 1982), pp. 1789-1816.

[4]For technologies characterized by economies of scale or high fixed costs, marginal cost will be less than average cost so that prices set at marginal cost will not recover the total cost of the firm. Firms in such markets must set prices above incremental cost -- either on average or for particular customers through non-linear pricing. The difference between price and incremental cost for such firms is not a consequence of market power in the sense that it would not disappear if the market became more competitive. Indeed, with economies of scale, entry and competition that divides market output across more competitors would have the effect of increasing the difference between price and incremental cost, rather than reducing it.